

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions	:	
of	:	
172 FRANKLIN STREET, INC. D/B/A	:	DETERMINATION
THE BUFFALO HOUSE AND DAVID C. FORNESS	:	DTA NOS. 816713
	:	AND 816714
for Revision of Determinations or for Refund of Sales and	:	
Use Taxes under Articles 28 and 29 of the Tax Law for the	:	
Period September 1, 1992 through August 31, 1995.	:	

Petitioners, 172 Franklin Street, Inc. d/b/a The Buffalo House, 172 Franklin Street, Buffalo, New York 14202, and David C. Forness, 501 Delaware Avenue, Buffalo, New York 14202, filed petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period September 1, 1992 through August 31, 1995.

A consolidated hearing was held before Roberta Moseley Nero, Administrative Law Judge, at the offices of the Division of Tax Appeals, 77 Broadway, Suite 112, Buffalo, New York, on June 22, 1999 at 10:30 A.M., with petitioners' reply brief received on December 17, 1999, which date began the six-month period for the issuance of this determination. Petitioners appeared by Gary M. Kanaley, Esq. The Division of Taxation appeared by Barbara G. Billet, Esq. (Dennis A. Fordham, Clifford Peterson and Cynthia E. McDonough, Esqs., of counsel).

ISSUES

I. Whether the indirect audit methodology utilized by the Division of Taxation was reasonable.

II. Whether the evidence produced at hearing by petitioners requires any adjustments to the audit results.

III. Whether petitioners have shown reasonable cause for abatement of penalties.

FINDINGS OF FACT

1. The Division of Taxation (“Division”) issued a Notice of Determination (notice number L-013983293) to petitioner 172 Franklin Street, Inc. d/b/a The Buffalo House (“The Buffalo House”) dated August 11, 1997. The Notice of Determination reflected a tax due of \$70,756.26, interest of \$34,367.22 and penalty of \$28,302.53, for a total balance due of \$133,426.01. The penalty due of \$28,302.53 was for both statutory and omnibus (for underreporting in excess of 25%) penalties.

2. The Division issued a Notice of Determination (notice number L-014040365) to petitioner David C. Forness dated August 28, 1997. The Notice of Determination reflected a tax due of \$70,756.26, interest of \$34,956.31 and penalty of \$28,302.53, for a total balance due of \$134,015.10. The penalty due of \$28,302.53 was for both statutory and omnibus (for underreporting in excess of 25%) penalties. The notice states that it was issued to Mr. Forness because he was a responsible officer of The Buffalo House.

3. The Buffalo House was described during the audit and these proceedings as a tavern whose business during the audit period included sales of beer, wine, liquor and food. Food sales consisted of “tavern” type food, such as sandwiches, salads, chicken wings, etc. (i.e., the business did not operate as a formal restaurant). There was a bar with a space for eating located in the front of the establishment and a second space for eating in the back.

4. Mr. Forness has been involved with The Buffalo House at least since 1982. Prior to becoming involved with the tavern business, Mr. Forness had taught sixth grade in the City of Buffalo for 18 years.

5. During the audit period Mr. Forness was a stockholder in The Buffalo House and had the authority to sign checks on behalf of The Buffalo House without obtaining any other signature. Mr. Forness was the only officer of The Buffalo House who signed sales tax returns during the audit period and was the only officer to appear on behalf of The Buffalo House during the audit. On September 1, 1996 Mr. Forness signed a power of attorney authorizing Gary M. Kanaley, Esq., to represent The Buffalo House regarding the audit at issue in this matter. Mr. Forness signed the power of attorney as president of The Buffalo House. Mr. Forness did not contest in his petition, nor at any time during these proceedings, the Division's conclusion that he was a responsible person or officer of The Buffalo House during the audit period. Therefore, Mr. Forness's status as such a responsible person or officer is not at issue in these proceedings.

6. At the beginning of the hearing in this matter the parties stipulated on the record that Mr. Forness's liability as a responsible person or officer of The Buffalo House was limited to the period June 1, 1994 through August 31, 1995 for a tax due of \$28,041.23 plus applicable interest and penalty. The Division stated that this agreement to a reduction in tax due from Mr. Forness as a responsible person or officer of The Buffalo House was required by *Matter of Bleistein* (Tax Appeals Tribunal, July 27, 1995 [separate consents to extend the statute of limitations are required for a corporation and any person assessed as a responsible person or officer of the corporation])).

7. On September 25, 1995 the Division's auditor contacted The Buffalo House by telephone and left a message for Mr. Forness. The purpose of the telephone call was to inform

Mr. Forness that an audit of The Buffalo House was to be conducted, schedule an appointment and make an initial verbal request for records. On September 26, 1995 Mr. Forness returned the auditor's telephone call and informed the auditor that all of The Buffalo House's records were with Mr. Thomas Yaiko the accountant. Since the accountant was on vacation until October 2, 1995 the auditor waited until that date to telephone him and leave a message. On October 3, 1995 the accountant called the auditor back and made an appointment for October 31, 1995 to begin the audit. The auditor informed the accountant that she needed to receive a power of attorney from him prior to sending him the appointment letter. The power of attorney was received by the auditor on October 26, 1995. An appointment letter dated October 30, 1995 and setting an appointment for November 14, 1995 was sent by the auditor to The Buffalo House with a copy to the accountant with the following request for records:

All books and records pertaining to your sales and use tax liability for the period under audit are to be available on the appointment date. This would include journals, ledgers, sales invoices, purchase invoices, cash register tapes, sales and use tax returns, federal income tax returns, and exemption certificates. Exemption certificates not made available may be disallowed in which case you will be held liable for the tax on the transaction.

During the course of the audit, you may be required to furnish additional records and/or information.

8. At the November 14, 1995 appointment petitioners provided the Division with bank statements and taxpayer worksheets showing sales figures which Mr. Forness had previously provided to the accountant. Also provided were some purchase invoices from the period February 1995 through November 1995. The auditor reviewed these records at that time. She determined that while the sales figures contained in the taxpayers' worksheets could be reconciled with the bank deposits, there was no method available to her to verify these sales

figures because there was no source documentation of sales. Therefore, the auditor determined to conduct a third-party verification of purchases.

9. On November 20, 1995, the auditor sent requests for information to those suppliers listed on the purchase invoices that had been supplied. She also telephoned the accountant and asked that he find out the names of the remainder of The Buffalo House's suppliers. The auditor sent requests for information to those suppliers provided by the accountant in response to that request and also to other suppliers that she was aware of in the Buffalo area based on her prior audit experiences.

10. The auditor mailed letters to all beer, wine and liquor distributors in the Buffalo, New York area. The letter to the distributors requested that they provide the Division with the total sales made to The Buffalo House during the audit period and that the sales be summarized on a monthly basis. It appears that all suppliers receiving the auditor's inquiry responded. Since retailers such as The Buffalo House are only allowed to purchase beer, wine and liquor from registered distributors and the names of those distributors in the Buffalo area are known because they are few in number, the auditor felt comfortable that she had an accurate and total picture of The Buffalo House's beer, wine and liquor purchases during the audit period.

11. The auditor requested that Mr. Forness complete a Bar Fact Sheet. A Bar Fact Sheet, dated December 6, 1995, was completed by Mr. Forness and returned to the auditor. The Bar Fact Sheet for liquor and wine listed type of drink, method dispensed (i.e., shot glass, free pour or automatic dispenser), ounces served per drink, selling price (with three subcolumns for regular, happy hour and "entertain") and brands. The portion of the Bar Fact Sheet for beer was the same except that instead of type of drink it listed grade of beer and instead of method dispensed it listed container served (i.e., glass, pint, pitcher). Mr. Forness completed the

worksheet with different entries for each of the years 1993, 1994 and 1995. All regular prices were listed. Happy hour prices were listed for each year for: liquor, except for top shelf liquor; local and Canadian draft beer in a ten ounce glass; house wine; and local and Canadian bottled beer. No prices were listed in the “entertain” column.

12. To calculate total sales for bottled beer during the audit period the auditor started with the purchase invoices received from the distributors and determined from the invoices the total number of bottles of beer purchased and therefore available for sale during the audit period (the number of cases of bottled beer purchased multiplied by 24 bottles in each case).

The auditor then multiplied the total number of bottles of beer available for sale by the selling price of the bottles of beer (taken from the Bar Fact Sheet) to arrive at total sales for the audit period. The cost of goods sold (taken from the purchase invoices) was then subtracted from the total sales to arrive at a gross profit figure. The gross profit divided by the cost of goods sold resulted in a markup percentage. Separate markup percentages were calculated for domestic beer (including Canadian beer) and imported beer. Domestic beer was 294% and imported beer was 185%.

At a later date, apparently during discussions with The Buffalo House’s representative, the auditor recalculated the markup by applying a 15% spillage factor (*see*, Finding of Fact “17”) to the total sales for both domestic beer (including Canadian beer) and imported beer to arrive at final total sales figures. She then subtracted the cost of goods sold (taken from the purchase invoices) from the final total sales to arrive at a gross profit figure. The gross profit divided by the cost of goods sold resulted in a markup percentage. Separate markup percentages were calculated for domestic beer (including Canadian beer) and imported beer. The domestic beer markup was 235% and the imported beer markup was 142%.

13. To calculate total sales of draft beer during the audit period the auditor started with the purchase invoices received from the distributors and determined from the invoices the total number of kegs purchased during the audit period. The auditor then contacted the distributors who provided the purchase information to determine the number of ounces of beer in each keg since there were several different sizes of kegs. The number of ounces in each keg multiplied by the number of kegs purchased resulted in a total number of ounces purchased. The auditor then applied a 15% spillage factor to the ounces of beer purchased (*see*, Finding of Fact “17”), and subtracted such amount from the total ounces purchased to arrive at a total number of ounces of beer available for sale for the audit period.

The auditor determined from the Bar Fact Sheet that The Buffalo House sold draft beer in 3 different size containers: a 10-ounce glass, a 14-ounce glass and a 64-ounce pitcher. She then inquired of Mr. Forness as to allocation of the sales of each of these sizes to total sales. Mr. Forness told the auditor that 10-ounce glass sales represented 60% of sales, 14-ounce sales represented 20% of sales, and 64-ounce pitchers represented 20% of sales. The auditor then multiplied each of these percentages by the total ounces available for sale to arrive at the total ounces available for sale for each of the sizes. Each of these totals was divided by the number of ounces in the corresponding container to arrive at the number of containers sold for each size container.

The auditor then multiplied the number of containers sold for each size container by the appropriate selling price of the container of beer (taken from the Bar Fact Sheet) to arrive at total sales for the audit period for each size container. The auditor then calculated total sales for the audit period for all three size containers. The cost of goods sold (taken from the purchase

invoices) was then subtracted from the total sales to arrive at a gross profit figure. The gross profit figure divided by the cost of goods sold resulted in a markup percentage.

Separate markup percentages were calculated for domestic bottled beer (including Canadian beer) and imported bottle beer. The markup for domestic beer was 292%. The markup as originally calculated for imported beer was 139%. Based upon the auditor's experience this markup was too low for imported draft beer. She therefore adjusted the markup for imported draft beer to equal her original calculation of the markup for imported bottled beer of 185%. (185% was the markup on imported bottled beer prior to applying the 15% spillage factor, which in the case of the imported draft beer had already been applied to the number of ounces available for sale.)

14. The markups for domestic bottled beer, imported bottled beer, domestic draft beer and imported draft beer were applied to the total purchases (taken from the purchase invoices) resulting in total beer sales of \$566,713.24 for the audit period.

15. To calculate total sales for wine and liquor during the audit period the auditor again started with the purchase invoices received from the distributors. She first determined percentages of purchases for each of five categories: house wine, call wine, house liquor, call liquor and top shelf liquor. The categories were necessary because there were different prices for the drinks sold in each of those categories. The remainder of the calculations were done for each of the five categories.

The auditor determined from the invoices the total number of ounces purchased during the audit period (based on the number of bottles purchased and the size of the bottles). The auditor then applied a 15% spillage factor (*see*, Finding of Fact "17"), which was subtracted from

the total ounces purchased to arrive at a total number of ounces available for sale for the audit period.

The auditor then divided the total ounces available for sale by the number of ounces in a drink (taken from the Bar Fact Sheet) to determine the number of drinks sold. The auditor then multiplied the number of drinks sold by the appropriate selling price of the drinks (taken from the Bar Fact Sheet) to arrive at total sales for the audit period for each of the five categories. The auditor then calculated total sales for the audit period for all five categories. The cost of goods sold (taken from the purchase invoices) was then subtracted from the total sales to arrive at a gross profit figure. The gross profit figures divided by the cost of goods sold resulted in a markup percentage.

The five separate markup percentages calculated were: house wine - 187%, call wine - 160%, house liquor - 700%, call liquor - 585% and top shelf liquor - 462%.

16. The markups for house wine, call wine, house liquor, call liquor and top shelf liquor were applied to the total purchases (taken from the purchase invoices) resulting in total wine and liquor sales for the audit period of \$197,190.18.

17. The Division's audit guidelines provide for a "15% spillage factor" to be taken into account by an auditor conducting a sales tax audit of establishments such as The Buffalo House. Pursuant to such guidelines this factor is applicable to liquor, wine sold by the glass, draft beer and bottled beer. The spillage factor includes allowances for spillage, overpouring, pilferage, employee drinks (with certain exceptions not relevant to the present matter), and complimentary drinks.¹ The audit guidelines also note that those portions of this 15% allowance that represent

¹References in this determination to the Division's use of a spillage factor shall be understood to include all of these allowances.

employee and complimentary drinks are subject to use tax and that should be determined by the auditor.

18. The Buffalo House's total food sales during the audit period were also calculated by first contacting various food suppliers to determine The Buffalo House's food purchases for the audit period. The names of the food suppliers to contact were originally determined by utilizing information from whatever invoices were available and names of suppliers provided by The Buffalo House's accountant. These food suppliers were contacted by letter and asked to provide information on food purchases during the audit period. The auditor, based on her knowledge that The Buffalo House could purchase food supplies anywhere (as contrasted to alcoholic beverages purchases which could only be made from a limited number of distributors), also sent requests for purchase information to other food suppliers in the Buffalo area with whom she was familiar based on her audit experience. The auditor's workpaper VIII (the calculation of food sales for the audit period) lists a total of ten food suppliers from whom The Buffalo House purchased food during the audit period. One food supplier, Will Poultry Co., stated that to the best of its knowledge The Buffalo House had not made any purchases from it during the audit period.² The auditor totaled the food purchases for the audit period. Instead of taking individual items of food and transforming them to meal items sold and then applying sales prices for those items, the auditor determined to use what she referred to as a standard markup or ideal markup of 233% for the industry. The auditor's workpaper VII shows that the calculation of total food sales for the audit period utilized a standard markup of 100%.

²This fact is contrary to the auditor's testimony during the hearing that Will Poultry Co. did not respond to her request for information. However, the statement was made in a letter dated January 4, 1996 addressed to the auditor that is part of Division's Exhibit N-3. The transcript indicates that the auditor testified that "Wilt Poultry" did not respond to her request. Since there is no indication in the documents submitted that a letter was sent to anyone other than Will Poultry Co., the transcript is deemed corrected to read Will Poultry on page 50.

19. Prior to the issuance of the notices in this matter the auditor met with petitioners' representative who provided alternative calculations of tax due that had been prepared by the accountant. These calculations included allowances for "give aways," self consumption, theft by bartenders, owner set-ups, "policemen discounts" and "Happy Hours." There is no evidence in the record as to how the accountant arrived at the percentages for each of these allowances.

At a later date Mr. Forness and his brother, who is a banker, prepared another calculation of additional taxes due for the audit period. These calculations were prepared using the books and records of The Buffalo House for a period after the audit period and show only the amounts of the purchases, "revised percentages"(or markups) and "revised sales." The total additional tax due shown is \$12,214.32. The calculations prepared by Mr. Forness and his brother reflect a food markup of 26%.

20. In August of 1992 Mr. Forness suffered a heart attack requiring some hospitalization. In September of 1992 Mr. Forness returned to work for approximately two hours per day until January of 1993 when he started working six hours a day. It was approximately another year before Mr. Forness returned to work full time. Assisting Mr. Forness at least from August of 1992 until January of 1993 were his sisters Donna, who was a teacher and was able to help after school, and Kelly, who worked at a similar establishment. Also assisting Mr. Forness during that time and continuing presently was his brother Clarence, who is a banker and who helps on weekends. Mr. Forness felt comfortable leaving his business in the hands of his family while he needed assistance due to his medical problems. He did not think that hiring a manager was an option available to him based upon finances.

During this time Mr. Forness was not always at The Buffalo House, and the business experienced greatly increased thefts due to lack of constant supervision of the employees. He

estimated his theft losses during this period at 30%. Mr. Forness was not able to explain how he determined the 30% figure.

21. Sometime during September of 1995 there was flooding in the basement of The Buffalo House's tavern. A plumber's job work order dated September 26, 1995 was submitted into evidence by petitioner stating that the plumber ran a sump pump in the flooded basement for four hours and performed certain repair work. Whatever records, dry goods or food supplies that were in the basement at the time had to be thrown out. Mr. Forness made no mention of any problems with flooding to the auditor at any time during the course of the audit.

SUMMARY OF THE PARTIES' POSITIONS

22. Petitioners argue that the audit was flawed in that the calculations did not provide for the following: "Happy Hours" and several other promotions; greater than usual theft problems due to Mr. Forness's medical condition making it impossible for him to supervise The Buffalo House as well as usual for a major portion of the audit period; drinks such as "on the rocks" which required more ounces to be served than the information on the Bar Fact Sheet indicated; any theft of food, food spoilage or food giveaways such as complimentary hors d'oeuvres during happy hours; the fact that The Buffalo House is a tavern and has a smaller markup than a restaurant as admitted by the auditor; all but one food supplier responded to the auditor's request for information (as opposed to the auditor's assumption that not all food suppliers were represented); and losses due to spillage of a far greater amount than allowed by the auditor. Petitioners also argue that their estimates of tax due are more reasonable than the auditor's taking into consideration all of the above factors, the alleged destruction of The Buffalo House's records in a flood, and Mr. Forness's allegation that the original returns filed were based upon

the required records. Finally, petitioners argue that based upon all of these factors they have not manifested the required intent for the imposition of penalties.

23. The Division argues that the audit was rational because an estimated audit was required due to petitioners' lack of records. The calculations utilized were based on the information Mr. Forness provided on the Bar Fact Sheet, the information provided by the suppliers and an industry standard markup, and this type of audit has been upheld in the past. The Division argues that petitioners must prove the methodology used was unreasonable or the amounts determined erroneous. The Division argues that petitioners' assertions that the 15% spillage factor utilized by the auditor was insufficient to cover real loss from use by employees, give aways, thefts and promotions was not proven in that Mr. Forness's vague testimony on these issues is not clear and convincing evidence (e.g., there was no evidence to verify promotions such as other witnesses or advertisements). In any event the Division argues that the "losses" due to self, employee and free customer consumption are subject to use tax which was not assessed. With regard to the food markup the Division argues that the industry standard 233% was utilized and reduced to 100% based upon the auditor's experience which was reasonable considering that no major poultry supplier was included in the food purchases. The Division also argues that petitioners have failed to prove reasonable cause to abate penalties. Petitioners did not show that sufficient records existed that would have allowed a complete audit especially since Mr. Forness originally told the auditor that the accountant had the records, and even though the records required were allegedly destroyed at approximately the same time the audit was initiated, Mr. Forness never mentioned this to the auditor. Even if true, the records existed at the time of the audit and petitioners still underreported their sales taxes by 68%. Petitioners were on notice of the required books and records due to a previous audit.

24. Petitioners in their reply do not dispute the right of the Division to utilize an indirect audit in this matter. Further, petitioners concede that there did exist miscommunication between petitioners and the Division during the course of the audit. However, petitioners argue that their estimates are more reasonable than the auditor's based upon the Division's failure to take into account all of the factors mentioned above.

CONCLUSIONS OF LAW

A. There is no dispute that the audit methodology utilized in this matter was an indirect methodology not based solely on the books and records of The Buffalo House. In order for the Division to utilize an indirect methodology, it must show that it made an adequate request for books and records for the entire audit period (*see, Matter of Christ Cella v. State Tax Commn.*, 102 AD2d 352, 477 NYS2d 858), and that it reviewed the records provided in order to determine that the records were inadequate for the purposes of conducting a complete audit (*see, Matter of King Crab Rest. v. Chu*, 134 AD2d 51, 522 NYS2d 978).

The original appointment letter sent by the Division to The Buffalo House constituted an adequate request for books and records and covered the entire audit period currently at issue. This was followed by several other conversations discussing the records to be provided and meetings wherein records were requested. The records provided to the Division in response to these requests were reviewed and determined to be inadequate. Petitioners have not asserted that the Division did not make an adequate request for books and records or that they submitted adequate books and records to the Division. Petitioners' reply brief specifically states that the Division's right to conduct this audit by utilizing an indirect audit method is undisputed. Therefore, it was acceptable for the Division to calculate petitioners' tax liability based on estimated or indirect audit methods.

B. Pursuant to Tax Law § 1132(c)(1), petitioners bear the burden of proving by clear and convincing evidence that the tax assessed was erroneous (*Matter of Rizzo v. Tax Appeals Tribunal*, 210 AD2d 748, 621 NYS 2d 115; *Matter of Mobley v. Tax Appeals Tribunal*, 177 AD2d 797, 799, 576 NYS 2d 412, *appeal dismissed* 79 NY2d 978, 583 NYS2d 195; *Matter of Surface Line Operators Fraternal Line Organization v. Tully*, 85 AD2d 858, 446 NYS2d 451). Furthermore, a presumption of correctness attaches to a notice issued by the Division, and the taxpayer must overcome this presumption (*see, Matter of Suburban Carting Corporation*, Tax Appeals Tribunal, May 7, 1998, citing *Matter of Tivolacci v. State Tax Commn.*, 77 AD2d 759, 431 NYS2d 174; *Matter of Leogrande*, Tax Appeals Tribunal, July 18, 1991, *confirmed* 187 AD2d 768, 589 NYS2d 383, *lv denied* 81 NY2d 704, 595 NYS2d 398).

The Division may resort to an estimated or indirect audit method to calculate sales tax due where a taxpayer has failed to present books and records adequate for the Division to conduct a detailed audit (*see, Matter of Urban Liquors v. State Tax Commn.*, 90 AD2d 576, 456 NYS2d 138). While the method chosen by the Division must be reasonable (*see, Matter of House of Audio of Lynbrook, supra*) and reasonably calculated to reflect the taxes due (*see, Matter of W.T. Grant v. Joseph*, 2 NY2d 196, 159 NYS2d 150, *cert denied* 355 US 869, 2 L Ed 2d 75; *Matter of Ristorante Puglia, Ltd. v. Chu*, 102 AD2d 348, 478 NYS2d 91), the method need not be exact (*Matter of Markowitz v. State Tax Commn.*, 54 AD2d 1023, 388 NYS2d 176, 177, *affd* 44 NY2d 684, 405 NYS2d 454) and the auditor is given considerable latitude in devising an audit method (*Matter of Grecian Sq. v. New York State Tax Commn.*, 119 AD2d 948, 501 NYS2d 219, 221). However, when the reasonableness of an audit is questioned by a petitioner there must be sufficient evidence in the record to enable the trier of fact to determine that the

Division established a rational basis for this audit (*Matter of Grecian Sq. v. New York State Tax Commn., supra*).

C. With regard to the calculations concerning the bottled and draft beer and wine and liquor sales the Division has shown a rational basis for the audit method utilized. Furthermore petitioners have not met their burden of proof of showing that the audit methodology was unreasonable or that the Division's determination of tax due was erroneous.

Based on the audit method described in Finding of Fact "12" through "17", sufficient evidence exists in this record to enable me to determine that the Division has established a rational basis for its audit methodology (*Matter of Grecian Sq. v. New York State Tax Commn., supra; see also, Matter of Caleri*, Tax Appeals Tribunal, August 11, 1988.).

The Division having established a rational basis for the audit, it is incumbent upon petitioners to show by clear and convincing evidence that the audit method was unreasonable (*Matter of Meskouris Bros. v. Chu*, 139 AD2d 813, 526 NYS2d 679, 681). Petitioners' only arguments in this regard are that the auditor did not take into consideration "Happy Hours" and other promotions, beverages which required a greater than average amount of alcohol, losses due to theft and self consumption, and spillage (due to foam, temperature changes, pouring and service spills). Petitioners contend that these factors amounted to losses far exceeding the 15% spillage factor allowed by the Division.

The determination of whether the method chosen by the Division was reasonable is based on the information available to the Division at the time of the issuance of the notice (*see, Matter of Continental Arms Corp. v. State Tax Commn.*, 72 NY2d 976, 534 NYS 2d 362; *Matter of Northern States Contracting Co.*, Tax Appeals Tribunal, February 6, 1992). On the issue of "Happy Hours" the Bar Fact Sheet provided by Mr. Forness to the Division listed different prices

for beverages sold during “Happy Hour” than for those listed as regular prices. However, when the auditor questioned Mr. Forness he told her that The Buffalo House did not have “Happy Hours.” It was reasonable for the auditor to rely on this response at the time it was made, since it came from Mr. Forness in direct response to her question. With regard to “Happy Hours” and certain other issues raised by petitioners it is true that prior to the issuance of the notice in this matter the auditor met with petitioners’ representative who provided alternative calculations of tax due that had been prepared by the accountant. These calculations included allowances for “give aways,” self consumption, theft by bartenders, owner set-ups, “policemen discounts” and “Happy Hours.” There is no evidence in the record as to how the accountant arrived at the percentages for each of these allowances. The record reflects that petitioners were going to attempt to provide proof of these various items. However, no further proof of these items was presented. With the limited information available to the auditor at the time the notices were issued, it must be held that the audit method utilized was reasonable.

Having determined that the audit method had a rational basis and was reasonable, it is petitioners’ burden to prove not only that adjustments are required, but the amount of those adjustments (*see, Matter of Rizzo, supra; Matter of Pizza Works*, Tax Appeals Tribunal, March 21, 1991). To prove the amount of the adjustments to which they were entitled petitioners submitted a calculation of additional taxes due for the audit period prepared by Mr. Forness’s brother who is a banker. These calculations show only the amounts of the purchases, “revised percentages” and “revised sales.” The total additional tax due shown is \$12,214.32. The revised percentages were calculated using the books and records of The Buffalo House for a period after the audit period. There is no other evidence as to the amount of any adjustments that should be made except for the testimony of Mr. Forness. Mr. Forness recalled that The Buffalo House did

have “Happy Hours” and other promotions during the audit period and that there were losses due to theft and spillage that were greater than what was allowed for in the 15% spillage factor.

However, Mr. Forness was not able to quantify these factors in any manner. With the exception of theft losses which he estimated at 30%, he was not even able to estimate the other factors.

Therefore, the evidence submitted by petitioners consists only of their estimates of what the tax due should be. Because of petitioners’ lack of books and records, the Division was required to perform this audit by utilizing an indirect method. Under these circumstances the Division is not required to have an exact audit and petitioners cannot prove the amount of adjustments required simply by submitting their own estimates (*Matter of Rizzo, supra; Matter of Pizza Works, supra*).

D. With regard to the calculations concerning The Buffalo House’s food sales, the record does not contain sufficient information upon which to determine that the audit methodology had a rational basis.

Again, there were no sales records available, so the auditor utilized purchase records obtained from suppliers to calculate food sales. The Division obtained the names of the food suppliers from the purchase invoices provided by petitioners and from the accountant. The auditor also requested information from other food suppliers in the Buffalo area that she was aware of based on prior audits she had conducted. She did not take individual items of food purchases and translate them into meals to calculate a markup. Rather, the auditor used a markup of 233% which she stated was an industry standard. From the records she received from the food suppliers she calculated the total amount of food purchases made by The Buffalo House for the audit period. Then the auditor applied the industry standard markup to the food purchases to arrive at total food sales for the audit period. The auditor explained that she then adjusted the

markup percentage to 100% which she characterized as a more fair markup for purposes of attempting to settle the case prior to issuing the notices.

The auditor stated she felt comfortable in using the industry standard markup of 233% because she knew she did not have all of The Buffalo House's food purchase invoices. This conclusion is not supported by the record. The auditor first explained that food was different from alcoholic beverages in that alcoholic beverages could only be purchased from a certain number of distributors of all of whom the auditor was aware. Food on the other hand could be purchased anywhere. She then explained that she knew she did not have all of The Buffalo House's food invoices because she had no specific purchase invoices for chicken wings and The Buffalo House must have sold chicken wings because they are a major food item in Buffalo.³ The problem with this premise is that the auditor testified she relied on the fact that she had no response from Will Poultry a major food supplier of chicken wings. This testimony is rejected because it is contradicted by the Division's own documents which show that Will Poultry indeed responded and stated that it had not sold anything to The Buffalo House during the audit period. The auditor admitted that The Buffalo House could have purchased its chicken wings elsewhere. Having been informed by Will Poultry that it did not sell to The Buffalo House, there is no indication in the record that the auditor made any inquiry into where The Buffalo House purchased its chicken wings prior to reaching the conclusion that she did not have all of The Buffalo House's purchase records for the audit period.

There is a further problem with the calculations regarding food sales. Based on her assumption that she did not have all of the purchase information, the auditor then utilized an

³There is no contention that The Buffalo House did not sell chicken wings.

industry standard of 233% which she lowered to 100% for settlement purposes. There is no indication in the record as to the source of the information used for either the 233% or the 100% markup. The term industry standard is meaningless in the face of the questions raised by petitioners regarding the difference between a tavern and a full-service restaurant. It cannot be determined whether either percentage is an industry standard for either type of food seller. In fact, there is nothing in the record indicating where the industry standard came from such as the experience of the auditor's office (*see, Matter of Pizza Works, supra*) or some type of industry report (*see, Matter of 24 Hour Grocery and Candy*, Tax Appeals Tribunal, June 27, 1991). Furthermore, petitioners never agreed to the use of the 100% markup for food purchases (*cf., Matter of Mustafa*, Tax Appeals Tribunal, December 27, 1991 [figures arrived at through negotiation and agreed to by the parties indicate the figures are reasonable]). With all of these discrepancies I cannot hold that there is sufficient evidence in the record to conclude that the audit had a rational basis with regard to food sales. Therefore, the Division is directed to recalculate The Buffalo House's food purchases based on petitioner's markup of 26% and adjust the notices of determination accordingly (*see, Matter of Auriemma*, Tax Appeals Tribunal, September 17, 1992).

E. Tax Law § 1145(a)(1)(i) imposes a penalty on any taxpayer who fails to pay or pay over any tax within the required time limits, unless the failure to pay the tax was due to reasonable cause and not willful neglect. Tax Law § 1145(a)(1)(vi) imposes an additional penalty for substantial underreporting of tax (25% or more). Petitioners argue that they did not have the requisite intent to allow the Division to impose these penalties. However, lack of intent alone is

not grounds for the Division to not impose penalties or for the cancellation of penalties (20 NYCRR former 536.5[a]). Therefore, the penalties must be upheld.⁴

F. Petitioners requested a specific finding regarding the credibility of the testimony of Mr. Forness. Mr. Forness's testimony regarding the operations of the Buffalo House was credible. However, as noted in this determination, such testimony was lacking in detail and not supported by any documentary evidence. On the issue of whether complete books and records were available during the audit period but destroyed during the month the audit commenced, Mr. Forness again provided little in the way of detail. His testimony was credible to the extent that more records existed and there was flooding in the basement. However, the testimony was again vague as to what records existed and does not support a finding that complete books and records existed prior to the flooding. This finding is further supported both by Mr. Forness's failure to bring this point to the attention of auditor despite the proximity of the dates of the flooding and the commencement of the audit, and by Mr. Forness's statement to the auditor that the records of the Buffalo House were in the possession of the accountant.

G. The petition of 172 Franklin Street, Inc. d/b/a The Buffalo House is granted to the extent indicated in Conclusion of Law "D", but is in all other respects denied. The Notice of Determination issued to petitioner 172 Franklin Street, Inc. d/b/a The Buffalo House dated August 11, 1997, as modified by Conclusion of Law "D", is sustained.

The petition of David C. Forness is granted to the extent indicated in Finding of Fact "6" and Conclusion of Law "D", but is in all other respects denied. The Notice of Determination

⁴It does not appear that the adjustments required by Conclusion of Law "E" will lower the underreporting of petitioners to within 25% of the tax due. However, should this be the case the substantial underreporting penalty for that quarter would of course be canceled.

issued to petitioner David C. Forness dated August 28, 1997, as modified by Finding of Fact “6” and Conclusion of Law “D”, is sustained.

DATED: Troy, New York
June 15, 2000

/s/ Roberta Moseley Nero
ADMINISTRATIVE LAW JUDGE